By Ruth Lea
Economic Adviser to the Arbuthnot Banking Group

The Eurozone: better markets but a worsening economy

UK GDP for 2011Q4, due this Wednesday, is expected to show a small fall (0.1%) despite the seemingly buoyant December retail sales figures, which rose by 0.6% in the month. If GDP does show this modest quarterly drop then economic growth in 2011 was about 0.9%, compared with 1.8% in 2010.

A weak fourth quarter figure is much in line with the OBR's November forecasts and would suggest that growth in Britain is petering out.1 But growth is expected to pick up in the second half of 2012 as falling inflation reduces the squeeze on real incomes which so depressed household consumption last year. The economy will however struggle to recover against a background of recession and continuing crisis in the Eurozone.

Recent developments in the Eurozone

Over the last month there have been several key developments in the Eurozone.2 They are discussed below, in no particular order of significance.

(i) S&P's downgrades

The first development was the downgrading of nine of the 17 Eurozone countries by Standard and Poor's rating agency on 13 January.3,4 Most significantly France, along with Austria, lost its AAA rating and was downgraded one notch to AA+. Three of the four remaining AAA countries, Netherlands, Finland, Luxembourg, were assigned a negative outlook, indicating that S&P's believe that there is "at least a one-in-three chance that the rating will be lowered in 2012 or 2013". Germany is now the only AAA Eurozone country assigned a stable outlook by S&P's.

Seven other countries were downgraded. Cyprus, Italy, Portugal and Spain were downgraded 2 notches, whilst Malta, Slovakia and Slovenia were downgraded one. Significantly, Portuguese sovereign debt is now rated as "junk" grade by all three ratings agencies. The debt of Belgium, Estonia and Ireland was not downgraded, but the outlook for all three countries is now negative. Greek debt was not reassessed. The complete list of ratings by the three agencies for the Eurozone countries is shown in table 1, below.

S&P said that their reassessment of Eurozone debt reflected increased stresses in the currency bloc, which included (1) tightening credit conditions, (2) an increase in risk premiums for a widening group of Eurozone issuers, (3) a simultaneous attempt to de-lever by governments and households, (4) weakening economic growth prospects, and (5) an open and prolonged dispute among European policymakers over the proper approach to address challenges. They also expressed concern that the

EU leaders were treating the crisis as if it was purely a matter of fiscal profligacy (hence the fiscal compact treaty) which it clearly was not. And they emphasised that the ECB's actions, more below, can buy time, but cannot tackle the euro's underlying problems. It should be noted that the markets, unsurprised by S&P's actions, took the downgrades calmly.

The European Financial Stability Facility (EFSF) was also downgraded (from AAA to AA+) after the downgrades to France and Austria, as it is reliant on the ratings of its guarantors to raise cash in debt markets. The downgrade potentially curbs the EFSF's ability to contain the region's debt crisis and focuses more attention on efforts to create a more robust successor (namely, the European Stability Mechanism, due July 2012).

Table 1 Ratings for Eurozone countries and the European Financial Stability Facility (EFSF)

		Current rating, long-term issuer		
	S&P change to rating (13/1/12)	**Standard & Poor's**	**Moody's**	**Fitch**
Austria	Downgrade 1 notch from AAA	AA+/negative	Aaa/stable	AAA/stable
Belgium	No downgrade	AA/ negative	Aa3/negative	AA+/negative
Cyprus	Downgrade 2 notches	BB+/negative (junk)	Baa3/negative	BBB/negative
Estonia	No downgrade	AA-/negative	A1/stable	A+/stable
Finland	No downgrade	AAA/negative	Aaa/stable	AAA/stable
France	Downgrade 1 notch from AAA	AA+/negative	Aaa/stable	AAA/negative
Germany	No change	AAA/stable	Aaa/stable	AAA/stable
Greece	Not applicable	CCC (junk)	Ca (junk)	CCC (junk)
Ireland	No downgrade	BBB+/negative	Ba1/negative (junk)	BBB+
Italy	Downgrade 2 notches	BBB+/negative	A2/negative	A+/negative
Luxembourg	No downgrade	AAA/negative	Aaa/stable	AAA/stable
Malta	Downgrade 1 notch	A-/negative	A1/stable	A+/stable
Netherlands	No downgrade	AAA/negative	Aaa/stable	AAA/stable
Portugal	Downgrade 2 notches	BB/negative (junk)	Ba2/negative (junk)	BB+/negative (junk)
Slovakia	Downgrade 1 notch	A/stable	A1/stable	A+/stable
Slovenia	Downgrade 1 notch	A+/negative	A1/negative	AA-/negative
Spain	Downgrade 2 notches	A/negative	A1/negative	AA-/negative
ESFS	Downgrade 1 notch from AAA (16/1/12)	AA+	Aaa	AAA

Sources: (i) Standard & Poor's, www.standardandpoors.com (junk bonds: BB+ and below); (ii) Moody's, www.moodys.com (junk bonds: Ba1 and below); Fitch, www.fitchratings.com (junk bonds: BB+ and below).

(ii) Easing of tensions in the financial markets

The second development was the easing of tensions in the financial markets following the launch of the ECB's latest tonic for the banks in December. The tonic, in the form of nearly €500bn of very cheap, 3-year bank funding (Long Term Repo Operations (LTROs)),5 has significantly helped to stabilise European banks, some of which have been frozen out of the commercial funding markets for months. By easing the banks' funding pressures, the ECB action has undoubtedly instilled some optimism in the markets and there has even been talk that the Eurozone's problems are being "solved". They are not, of course, merely ameliorated.

There were successful French and Spanish auctions last week, undoubtedly helped by the ECB's huge liquidity boost, despite S&P's recent downgrades. But it is worth noting for all the outburst of optimism that 10-year bond yields remain high in Italy (6.3% on 20 January), Spain (5.5%) and Ireland (7.7%) - and extremely high in Portugal (14.6%) and Greece (34.8%). Fears are mounting that Portugal's position could become as unsustainable as Greece's. The notion that Greece's problems are a "one-off" could be just wishful-thinking.

(iii) The fiscal compact treaty

The third development is that the EU is making progress on the fiscal compact treaty, as originally agreed at the 9 December 2011 summit. The EU's latest draft will be discussed at the forthcoming summit on 30 January. At risk of repeating comments in recent Perspectives, it should be emphasised that this treaty does nothing to address the endemic competitiveness and growth problems at the heart of the Eurozone. Instead it focuses on the need for austerity as if this were a solution to the Eurozone's woes. It is basically an "updated" Stability and Growth Pact (SGP).6

(iv) Greece's second bailout package

The fourth development is that the crucial talks over Greece's €130bn second bailout package, initially agreed in July 2011, appear to have stalled.7,8 The most contentious issue remains the "haircuts" to be negotiated with the private-sector holders of Greek sovereign debt. It is widely accepted that default by Greece is not really a question of if, or even when, but how. Greece has to repay €14.5bn of debt on 20 March (as a bond matures) which could be the trigger for default unless there is agreement on extra bailout funds.

The negotiations are going on against a background of a deteriorating economic situation, exacerbating Greece's already parlous public finances. GDP probably shrank by 6% in 2011 (according to the Greek MOF), worse that the 5% fall forecast by the IMF in September.

(v) A deteriorating economic outlook

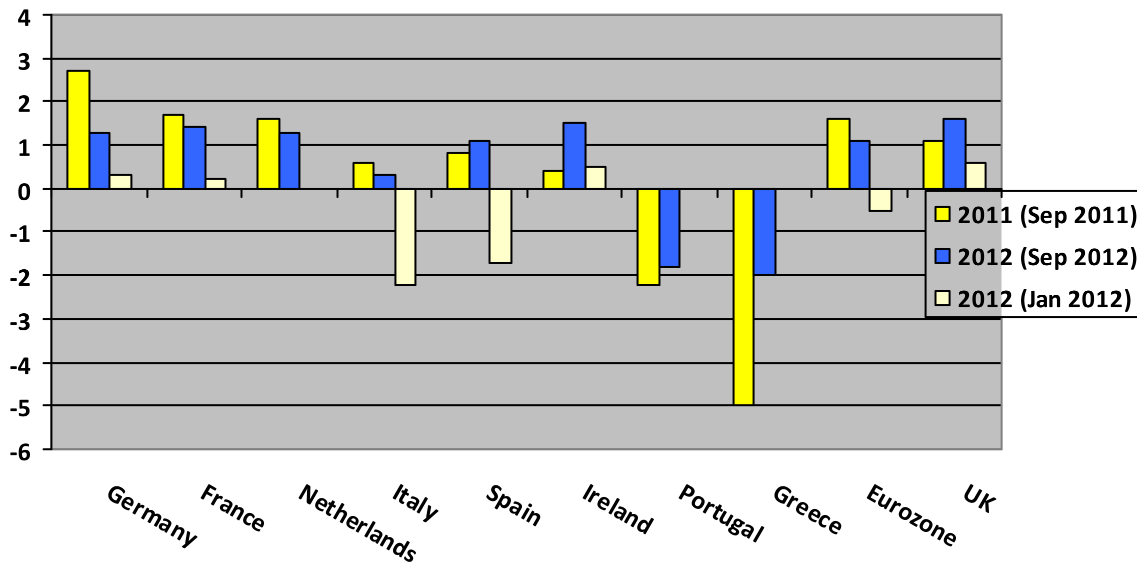
The final development concerns mounting evidence that the Eurozone's economy, not just Greece's, is deteriorating. Last week a leaked IMF paper contained some depressingly predictable downgrades to the Eurozone's growth prospects.9 The IMF's latest economic assessment should be seen as a "reality check" for those optimists in the financial markets.

The IMF now expects Eurozone GDP to fall by 0.5% this year compared with an increase of over 1% forecast for 2012 last September. Indeed the currency bloc is probably already in recession. Even Germany's GDP fell back by about 0.25% in the 2011Q4 as recovery petered out according to the Federal Statistics Office. The IMF now forecasts falls in output for both Spain (1.7%) and Italy (2.2%),

instead of September's expectations of modest growth, whilst the contraction in Greek and Portuguese GDP can only be expected to worsen. In addition, the troika (the European Commission, the IMF and the ECB) have cut Ireland's GDP growth figure for 2012 from over 1% to 0.5%.

Concerning the "big 3" EU economies, the UK is expected to be the fastest growing in 2012, at 0.6%, faster than Germany (0.3%) and France (0.2%). Chart 1 shows the IMF's September forecast along with estimates gleaned from the leaked January report.

Chart 1 IMF forecasts, GDP growth, YOY (%): Eurozone countries & UK



Source: (i) IMF, World Economic Outlook, September 2011; (ii) leaked January 2012 data from press reports for 2012; (iii) Ireland – "troika" figure for 2012 (January 2012).

As the IMF has recently conceded a deteriorating Eurozone economy, the World Bank has recently commented on the damage to non-EU countries from the Eurozone crisis. The World Bank has written "the world economy has entered a dangerous phase. Some of the financial turmoil in Europe has spread to developing and other high-income countries".10 The World Bank's forecast is almost as pessimistic as the IMF's. It expects Eurozone GDP (in PPP terms) to fall by 0.3% in 2012 after growing by 1.6% in 2011.

The competitiveness gap

As we have discussed in previous Perspectives, the core of the Eurozone's difficulties is the competitiveness gap, and related trade imbalances, between the northern competitive economies, predominately Germany, and the southern economies, including Italy and Spain.11 Some estimates suggest that the southern economies would need a 30-40% devaluation (or equivalent by internal deflation) in order to compete with the northern economies. In order to get some competitiveness into these economies, they need some, or all, of:

- Structural reforms. Italy has recently announced some reforms, including a modest increase in infrastructure spending.12 But structural reforms take time to feed though an economy and devaluation would be much quicker to act.

- Orderly restructuring of sovereign debt to put a country's debts on a more sustainable footing. But this has been avoided to date for reasons of moral hazard and concerns over the banks, which hold much of the debt.
- Devaluation, which is not possible within the Eurozone, severely limiting what can be done.

Another information source for assessing the competitiveness gap is the World Economic Forum (WEF)'s competitiveness indicators. (Note that the annual WEF meeting is occurring in Davos later this week (25 -29 January).) The WEF calculates these indicators annually.13,14 The WEF defines "competitiveness" as "the set of institutions, policies, and factors that determine the level of productivity of a country". The level of productivity, in turn, sets the "sustainable level of prosperity" that can be earned by an economy.

The WEF publishes Global Competitiveness Indicators (GCIs) for over 140 countries. They are principally calculated from the results of the WEF's extensive Executive Opinion Survey, though additional information is used where this is considered relevant. The survey questions ask for responses on a scale of 1 (the worst outcome) to 7 (the best outcome). The answers are then weighted for each country to give an overall score (GCI), with the top countries in the resulting league table achieving the highest scores (of course) and the bottom countries achieving the lowest.

In 2011 Switzerland and Singapore were judged the most competitive economies, followed by Sweden. Table 2 below gives the results for the EU and graphically confirms the gap between the northern Eurozone countries and the southern. The northern Eurozone countries, including Finland, Germany and the Netherlands, cluster towards the top of the table, whilst Italy, Portugal, and especially Greece are further down the table. Greece's position is especially dire, lower than Bulgaria and Romania. Not by any stretch of the imagination can the Eurozone economies be regarded as compatible, converged or even converging.

Table 2 How competitive is the EU? The WEF Global Competitiveness Index, 2011

Economy (* Eurozone)	Rank (out of 142)	Score (maximum, 7)
Scores: 5-6		
Sweden	3	5.61
Finland*	4	5.47
Germany*	6	5.41
Netherlands*	7	5.41
Denmark	8	5.40
UK	10	5.39
Belgium*	15	5.20
France*	18	5.14
Austria*	19	5.14
Luxembourg*	23	5.03
Scores: 4-5		
Ireland*	29	4.77
Estonia*	33	4.62
Spain*	36	4.54
Czech Republic	38	4.52
Poland	41	4.46
Italy*	43	4.43
Lithuania	44	4.41
Portugal*	45	4.40
Cyprus*	47	4.36
Hungary	48	4.36
Malta*	51	4.33
Slovenia*	57	4.30
Latvia	64	4.24
Slovak Republic*	69	4.19
Bulgaria	74	4.16
Romania	77	4.08

Scores: 3-4		
Greece*	90	3.92

Source: WEF, The Global Competitiveness Report 2011-2012, 2011, rankings of the EU27 in the Global Competitiveness Index. The EU17 are asterisked.

The need for growth policies

The current EU policy of imposing austerity packages on the uncompetitive southern European countries is leading to recessions and deepening recessions which, in turn, worsen their public finances. Without growth these countries are in "austerity traps". Joseph Stiglitz recently commented that European austerity packages are "suicide pacts", akin to medieval "blood-letting" which left the patient sicker than before.15 The language may be melodramatic but the sentiment is fair. Faced with catastrophe the EU's leaders continue to insist on austerity whilst doing little to help the patient onto his feet.

As the EU leaders obsess about austerity, far too little attention is being paid to growth policies. Aware of this fact, a Franco-German document emerged last week entitled "Ways out of the crisis - strengthen growth now!"16 (Please note the exclamation mark.) But the policy prescriptions amounted to little more than a reiteration of the need for the Financial Transactions Tax (aimed at the City of course), the convergence of corporate tax regimes (threatening Ireland's tax competitiveness), more energy taxes (to save the planet from dangerous global warming), Commission-administered regional funds and, quite sensibly, lower labour taxes (though it is not clear how they would be funded). These policies are more likely, on balance, to hinder rather than help growth.

A robust growth package has yet to be developed. It is long overdue.

References

1. OBR, Economic and fiscal outlook, November 2011.
2. Ruth Lea, "The EU's leaders need to plan for an orderly break-up of the euro", Arbuthnot Banking Group Perspective, 19 December 2011, was the last Perspective on the Eurozone.
3. "Standard & Poor's Takes Various Rating Actions On 16 Eurozone Sovereign Governments", 13 January 2012, www.standardandpoors.com
4. Ruth Lea, "The Eurozone debt crisis deepens", Arbuthnot Banking Group Perspective, 18 July 2011, discusses the ratings agencies further.
5. Economist blogs, "Cautious on the economy, happy with liquidity", 12 January 2012.
6. Ruth Lea, "The EU's leaders need to plan for an orderly break-up of the euro", Arbuthnot Banking Group Perspective, 19 December 2011.
7. Ruth Lea, "A second Greek bailout: nearly there", Arbuthnot Banking Group Perspective, 27 June 2011.
8. Sunday Telegraph, "Talks on Greece debt deal stalled", 22 January 2012.
9. Daily Telegraph, "IMF slashes global forecast on Eurozone crisis, with drastic falls for in Italy & Spain", 20 January 2012.
10. World Bank, Global Economic Prospects: Uncertainties and vulnerabilities, January 2012.
11. Ruth Lea, "Britain will struggle to avoid a "double dip" recession, as Eurozone growth prospects sour", Arbuthnot Banking Group, 7 November 2011.
12. Reuters, "Monti says markets must recognize Italian reforms", 12 January 2012.
13. WEF, The Global Competitiveness Report 2011-2012, 2011.
14. Ruth Lea, "Britain needs a radical pro-growth strategy", Arbuthnot Banking Group, 7 February 2011, discusses the methodology of the WEF surveys.
15. Daily Telegraph, "Stiglitz says European austerity plans are a 'suicide pact'", 17 January 2012.
16. EU Observer, "Franco-German 'growth' plan looks to EU funds and taxes", 20 January 2012.